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Voidable Preferences and Protection of the Expectation Interest

Thomas H. Jackson* and Anthony T. Kronman**

One of the principal duties of a trustee in bankruptcy is to marshal the unsecured assets of the bankrupt estate, liquidate them, and distribute the proceeds among the estate's unsecured creditors in a statutorily prescribed manner.¹ In performing this duty, the trustee enjoys a number of so-called "avoiding powers," carefully delimited in sections 60, 67 and 70 of the present Federal Bankruptcy Act.² These powers enable the trustee to set aside certain pre-petition transfers made by the bankrupt and to recover the transferred assets for the benefit of the bankrupt's unsecured creditors.³ Among the transfers subject to the trust-

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1. See Bankruptcy Act §§ 47, 70, 11 U.S.C. §§ 75, 110 (1970); see, e.g., J. MOORE & W. PHILLIPS, *DEBTORS' AND CREDITORS' RIGHTS* ch. 1, § 2 (1966); J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* § 24-1 at 865 (1972).

2. 11 U.S.C. §§ 96, 107, 110 (1970).

3. See generally *Cissell v. American Home Assurance Co.*, 521 F.2d 790 (6th Cir. 1975); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969); 2 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 45.3.1 *et seq.*, at 1289-1346 (1965).

The present Bankruptcy Act's "voidable preference" provision is found in section 60, 11 U.S.C. § 96 (1970). Although the section has become extremely intricate, due in large part to its treatment of the so-called equitable lien, see Friedman, *The Bankruptcy Preference Challenge to After Acquired Property Clauses Under the Code*, 108 U. PA. L. REV. 194, 200-04 (1959), the core of section 60 is contained in subsections (a) (1) and (b), 2 G. GILMORE, *supra*, § 45.4 at 1303. Section 60(a) (1) defines a preference as:

a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

Section 60(b) provides that "[a]ny such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent." Thus, a transfer may be avoided as preferential only after a number of distinct

ee's avoiding powers are those involving security interests.⁴ Those sections of the Bankruptcy Act that define the trustee's avoiding powers provide the principal forum for determining which pre-bankruptcy security transactions will survive the "acid test" of bankruptcy and which will not.⁵

elements are shown, see J. WHITE & R. SUMMERS, *supra* note 1, § 24-4 at 873; Seligson, *Preference Under the Bankruptcy Act*, 15 VAND. L. REV. 115 (1961).

Section 67 of the Bankruptcy Act, 11 U.S.C. § 107 (1970), contains two procedures for setting aside certain pre-petition transfers. Section 67(a) invalidates liens obtained through judicial proceedings within four months of bankruptcy "(a) if at the time when such lien was obtained such person was insolvent or (b) if such lien was sought and permitted in fraud of the provisions of this title." Section 67(d) is the Bankruptcy Act's own fraudulent conveyance section. It denounces as fraudulent all transfers made within one year of the filing of the petition for bankruptcy if, *inter alia*, "made or incurred without fair consideration by a debtor who is or will be thereby rendered insolvent, without regard to his actual intent . . .," or, "made or incurred with actual intent as distinguished from intent presumed in law, to hinder, delay, or defraud either existing or future creditors." 11 U.S.C. §§ 107(d) (2) (b), (d) (1970).

Section 70(c), 11 U.S.C. § 110(c) (1970), gives the trustee the status of a lien creditor, whether or not such a creditor of the insolvent debtor actually exists, "as to all property of the bankrupt at the date of bankruptcy whether or not coming into possession or control of the court." Section 70(e) allows the trustee to invalidate any transfer which, under state or federal law, "is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this title." "Fraudulent," in this formulation, means, as it has since *Twyne's Case*, 76 Eng. Rep. 809 (Star Chamber 1601), much more than "actual fraud." See *Irving Trust Co. v. Finance Serv. Co.*, 63 F.2d 694, 695-96 (2d Cir. 1933) (L. Hand, J.). Since the Bankruptcy Act contains, in sections 67(d) and 60, its own fraudulent conveyance and preferential transfer sections, the principal value of section 70(e) lies in the fact that it allows the trustee to take advantage of time limitations in a state's fraudulent conveyance or voidable preference law if longer than the time period in sections 67(d) or 60. See 3 COLLIER'S ON BANKRUPTCY ¶ 60.01 at 749 (14th ed. 1975); cf. *Barrett v. Bank of the Manhattan Co.*, 218 F.2d 763 (2d Cir. 1954) (L. Hand, J.).

4. Section 1(30) of the Bankruptcy Act, 11 U.S.C. § 1(30) (1970), defines a "transfer" as including:

. . . the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein or with the possession thereof, or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise; the retention of a security title to property delivered to a debtor shall be deemed a transfer suffered by such debtor.

5. See, e.g., Coogan & Vagts, *The Secured Creditor and the Bankruptcy Act: An Introduction*, in 1 P. COOGAN, W. HOGAN & D. VAGTS, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 972 (1963); MacLachlan, *The Impact of Bankruptcy on Secured Transactions*, 60 COLUM. L. REV. 593, 608 (1960).

In recent years, section 60 of the Bankruptcy Act—which empowers the trustee to avoid certain transfers characterized by the Act as “preferences”—has enjoyed a special pre-eminence in this regard.⁶ Although sections 67 and 70 have continued to generate their share of litigation,⁷ section 60 has been the focal point of the considerable controversy produced by the intersection of the Bankruptcy Act and the new law of chattel security embodied in Article 9 of the Uniform Commercial Code.⁸ The most persistently troublesome issue litigated under section 60 has been the appropriate treatment in bankruptcy of the security interest in after-acquired inventory and receivables broadly validated by the Article 9 “floating lien.”⁹

6. See 2 G. GILMORE, *supra* note 3, § 45.3.3 *et seq.* at 1298-1346; NATIONAL BANKRUPTCY CONFERENCE, REPORT OF THE COMMITTEE ON COORDINATION OF THE BANKRUPTCY ACT AND THE UNIFORM COMMERCIAL CODE 1 (1970) [hereinafter cited as 1970 GILMORE COMMITTEE]; Kronman, *The Treatment of Security Interests in After-Acquired Property Under the Proposed Bankruptcy Act*, 124 U. PA. L. REV. 110, 112 (1975).

7. See, e.g., *In re Smith*, 326 F. Supp. 1311 (D. Minn. 1971) (§§ 70(c), 70(e)(2)); *In re North American Builders, Inc.*, 320 F. Supp. 1229 (D. Neb. 1970) (§ 70(c)); *In re Vinarsky*, 287 F. Supp. 446 (N.D.N.Y. 1968) (§ 70(c)); *In re Babcock Box Co.*, 200 F. Supp. 80 (D. Mass. 1961) (§ 70(c)); *In re Buschmann*, 4 U.C.C. Rep. 260 (Ref. Dec. E.D. Wisc. 1967) (§ 70(c)). It is somewhat strange that the fraudulent conveyance provisions of sections 70(e) and 67(d) have been rarely used. Writing in 1972, J. WHITE & R. SUMMERS, *supra* note 1, § 24-9 at 892, stated that “it appears that there is not yet a single post-Code case in which the trustee has successfully invoked fraudulent conveyance law against an Article Nine secured creditor.”

8. Kronman, *supra* note 6, at 112, 115-16; NATIONAL BANKRUPTCY CONFERENCE, REPORT OF COMMITTEE ON COORDINATION OF UNIFORM COMMERCIAL CODE AND BANKRUPTCY ACT 1, 5 (1967) [hereinafter cited as 1967 GILMORE COMMITTEE].

9. The term “floating lien” refers to the various sections of Article 9 whereby

“a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral” (§ 9-204(1)); whereby “[o]bligations . . . may include future advances . . .” (§9-204(3)); whereby a security interest shifts automatically to the proceeds of collateral upon disposition thereof (§ 9-306); and whereby the rule of *Benedict v. Ratner*, 268 U.S. 353 (1925), is abrogated (§ 9-205).

Jackson & Kronman, A Plea for the Financing Buyer, 85 YALE L.J. 1, 1 n.1 (1975).

E.F. Corp. v. Smith, 496 F.2d 826 (10th Cir. 1974) (noted in 53 TEX. (L. REV. 1343 (1975))); *In re Wilco Forest Mach., Inc.*, 491 F.2d 1041 (5th Cir. 1974); *In re King-Porter Co.*, 446 F.2d 722 (5th Cir. 1971); *DuBay v. Williams*, 417 F.2d 1277 (9th Cir. 1969); *Grain Merchants, Inc. v. Union Bank & Sav. Co.*, 408 F.2d 209 (7th Cir.), *cert. denied sub nom.*, *France v. Union Bank & Sav. Co.*, 396 U.S. 827 (1969); *Owen & McKesson v. Robbins Drug Co.*, 349 F. Supp. 1327 (N.D. Fla. 1972), *aff'd mem.*, 486 F.2d 1401 (5th Cir. 1973); *In re Nickerson & Nickerson, Inc.*, 329 F.

A proposal currently before Congress would significantly revise the present Bankruptcy Act.¹⁰ Among its many sweeping reforms, the proposed Act would make a number of important changes in the language, structure, and scope of the present section 60.¹¹ In particular, the section that deals with voidable pref-

Supp. 93 (D. Neb. 1971), *aff'd per curiam*, 452 F.2d 56 (8th Cir. 1971); *Biggins v. Southwest Bank*, 322 F. Supp. 62 (S.D. Cal. 1971), *aff'd*, 490 F.2d 1304 (9th Cir. 1973); *In re White*, 283 F. Supp. 208 (S.D. Ohio 1967); *Rosenberg v. Rudnick*, 262 F. Supp. 625 (D. Mass. 1967); see also Friedman, *supra* note 3; Countryman, *Code Security Interests in Bankruptcy*, 75 COM. L.J. 269 (1970); Gordon, *The Security Interest in Inventory Under Article 9 of the Uniform Commercial Code and the Preference Problem*, 62 COLUM. L. REV. 49 (1962); Henson, "Proceeds" Under the Uniform Commercial Code, 65 COLUM. L. REV. 233 (1965); Hogan, *Games Lawyers Play with the Bankruptcy Preference Challenge to Accounts and Inventory Financing*, 53 CORNELL L. REV. 553 (1968); King, *Section 9-108 of the Uniform Commercial Code: Does it Insulate the Security Interest from Attack by a Trustee in Bankruptcy?*, 114 U. PA. L. REV. 1117 (1966); Krause, Kripke & Seligson, *The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property*, 42 N.Y.U.L. REV. 278, 282 (1967); Riemer, *Bankruptcy—Preference(s)—Conflict Between Section 9-108 of Uniform Commercial Code and Section 60(a) of Bankruptcy Act*, 70 COM. L.J. 63 (1965); Note, *After-Acquired Property Security Interests in Bankruptcy: A Substitution of Collateral Defense of the U.C.C.*, 77 YALE L.J. 139 (1967).

10. The proposed Act is sponsored by the Commission on Bankruptcy Laws of the United States. The Commission was created by the Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468, with a mandate to "study, analyze, evaluate, and recommend changes to the [Bankruptcy] Act. . . ." *Id.* The proposed Act was originally introduced in 1973, but did not pass that session, see H.R. 10792, 93rd Cong., 1st Sess. (1973). The Commission bill has recently been reintroduced, see S. 236, 94th Cong., 1st Sess. (1975), H.R. 31, 94th Cong., 1st Sess. (1975). A similar, but not identical, bill supported by the National Conference of Bankruptcy Judges is also before Congress, see S. 235, 94th Cong., 1st Sess. (1975); H.R. 32, 94th Cong., 1st Sess. (1975).

The proposed Act and its supporting commentary are found in REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, July 1973, pt. I, II, & III, H. Doc. No. 93-137, 93rd Cong., 1st Sess. [hereinafter cited as REPORT]. For a general discussion of some of the changes embodied in the proposed Bankruptcy Act, see SYMPOSIUM—BANKRUPTCY REFORM, 21 U.C.L.A.L. REV. 381 (1973). A brief discussion of the Act's legislative history is provided in Cyr, *The Bankruptcy Act of 1973: Back to the Drafting Board*, 48 AM. BANKR. L.J. 45 (1974).

11. The changes are contained in section 4-607 of the proposed Act. See REPORT, *supra* note 10, pt. I at 201-11, pt. II at 169-75; 1970 GILMORE COMMITTEE, *supra* note 6; Kronman, *supra* note 6; Note, *Section 60 Voidable Preferences and the UCC: A Hypothetical*, 9 GA. L. REV. 685 (1975). The Commission prepared a summary of the major changes included in the proposed Act. See REPORT, *supra* note 10, pt. I at 201-02:

The Commission recommends a substantial revision of the preference section of the present Act Preferences would fall into two categories: (a) preferences within three months

erences substantially modifies the treatment in bankruptcy of security interests in after-acquired property. These modifications have been discussed critically in a recent article by one of the authors.¹²

In support of their suggested changes in the treatment of security interests in after-acquired property, the draftsmen¹³ of section 4-607 of the proposed Act offered an interesting but ulti-

of the date of the petition; and (b) preferences between one year and three months of the date of the petition. As to the former, reasonable cause to believe that the debtor was insolvent at the date of the transfer would be immaterial, and insolvency would be presumed during the entire three month period preceding the date of the petition. As to the latter category of preferences, the familiar requirement of reasonable cause to believe the debtor was insolvent would be retained, and the trustee would have the burden of proving insolvency. Only transfers to persons having a close relationship to the debtor are open to attack under the latter category; they are members of the immediate family, partners, affiliates, directors, officers, and managing agents.

The Commission further recommends that certain transfers which are not within the policy reasons for the preference provisions be excepted from preference attack. Transfers of an aggregate value of less than \$1,000 to a creditor not closely related to the debtor during the three-month period are not subject to attack. Most absolute sales and all transfers in payment of debts for personal services, debts for utilities incurred within three months of the petition, and debts for inventory paid within three months of the delivery of the inventory in the ordinary course of debtor's business should not be subject to preference attack.

The Commission further recommends that the problems arising due to the interplay of the provisions of the Uniform Commercial Code and the Bankruptcy Act be put to rest by recognizing the validity of the after-acquired property clause as to inventory and receivable financing, but limiting its effects so that improvements in position during the three-month period at the expense of the estate may be set aside as preferential. The Commission also recommends that enabling loans be expressly protected and that protection given as a result of subsequent advances be increased.

In light of the recommendations of the Commission to shorten the period of vulnerability from four to three months and to eliminate the requirement of establishing reasonable cause to believe the debtor insolvent, the Commission recommends that a judicial lien be handled as any other preference. There no longer is a need for separate treatment.

12. Kronman, *supra* note 6.

13. The proposals of the Bankruptcy Commission concerning the treatment of voidable preferences (which are contained in section 4-607) closely track a revision of section 60 of the present Bankruptcy Act that was prepared for and accepted by the National Bankruptcy Conference. That revision was the product of the Conference's Committee on the Coordination of the Bankruptcy Act and the Uniform Commercial Code. Professor Grant Gilmore was the Chairman of the Committee. References in this article to "the draftsmen" of the voidable preference section of the proposed Act refer to the Gilmore Committee.

mately incomplete theory which attempts to articulate the principles that ought to govern the protection and avoidance, in bankruptcy, of all security interests of this sort.¹⁴ The draftsmen reasoned as follows: In his debtor's bankruptcy, a secured party should be permitted to retain only those benefits for which he has legitimately bargained. A secured party does not bargain for windfall gains that "accidentally" increase the value of his collateral. According to the draftsmen, any increase in the value of a debtor's inventory or receivables during the three month period immediately preceding his bankruptcy will almost certainly be the result of either a windfall gain—i.e., a gain not in "the normal course of a business declining into bankruptcy"¹⁵—or manipulative conduct on the part of an interested creditor. The debtor's trustee should therefore be empowered to avoid a security interest in inventory or receivables to the extent that the value of the collateral has increased during the three months prior to bankruptcy, if the debt was itself undercollateralized when the three month period began.

Underlying this analysis was the crucial, and we believe correct, assumption that the aim of any preference section must be

14. The Gilmore Committee stated that "[i]f a fair and sensible resolution of the underlying policy issues is available, . . . a statutory revision is indicated. . . ." 1970 GILMORE COMMITTEE, *supra* note 6, at 7. It recognized that the *DuBay* proposition, which prevented the avoidance in bankruptcy of any perfected Article 9 after-acquired property security interest "[went] beyond need or reason. . . ." Nonetheless, it warned that "the time has long since passed when it would have been possible to outlaw either inventory financing or receivables financing." *Id.* at 17. Recognizing these "facts of life," the Gilmore Committee set out to achieve a compromise.

The Commission on the Bankruptcy Laws of the United States also attempted to formulate a general theory of bankruptcy, which was not focused specifically on the concept of voidable preferences. See REPORT, *supra* note 10, pt. I, ch. 3 at 61-84 (entitled "A Philosophical Basis for a Federal Bankruptcy Act"). The Commission noted that no prior theory of bankruptcy law had ever been explicated:

No coherent, well developed general policy or philosophy has come to the Commission's attention that takes into account the scope of the Act and the experience under it. The major inadequacy of extant "philosophical" statements about bankruptcy is the failure to account for the overriding goals of the bankruptcy process in the context of its relationship with other economic and social processes, such as the credit economy.

Id. at 61. In particular, the Commission rejected the philosophical statement contained in Shuchman, *An Attempt at a "Philosophy of Bankruptcy,"* 21 U.C.L.A.L. REV. 403 (1973) (Professor Shuchman was Deputy Director of the Bankruptcy Commission). See Kennedy, *Forward: Bankruptcy Reform—1973*, 21 U.C.L.A.L. REV. 381, 390 (1973).

15. 1970 GILMORE COMMITTEE, *supra* note 6, at 17.

to balance the competing interests of secured and unsecured creditors. However, because they failed to identify these interests with sufficient precision, the draftsmen were led to mistakenly conclude that a secured party does not bargain for windfall gains.¹⁶ This error prevented the draftsmen from appreciating the extent to which the balance struck by section 4-607(d) interferes with the legitimate contractual expectations of a creditor with a security interest in inventory or receivables.¹⁷

Despite these flaws, the draftsmen intended their theory to serve as a general intellectual framework for systematically analyzing the concept of a voidable preference and the conflicting principles and interests which this concept embodies.¹⁸ The generality of the theory is its greatest virtue. Although an enormous amount has been written on the modern law of preferences, it is remarkable that no one has yet articulated a theory of comparable breadth.¹⁹

Historically, the law of voidable preferences developed as a branch of the law of fraudulent transfers.²⁰ For more than a

16. See text accompanying notes 80-83 *infra*.

17. See text accompanying notes 78-84 *infra*.

18. See 1970 GILMORE COMMITTEE, *supra* note 6, at 2, 15-16; note 28 *infra*. That the draftsmen found it necessary to construct a general theory of preferences in defense of their suggested changes regarding security interests in after-acquired property is understandable in light of their own statement that "the appropriate treatment of so-called revolving credit arrangements secured by inventory and receivables" presented the "most difficult problem" to be resolved in redrafting section 60. 1970 GILMORE COMMITTEE, *supra* note 6, at 2.

19. In its final report, the Gilmore Committee wrote "considerable progress has been made toward the goal of achieving as clear a statement of the underlying issues (which are themselves obscure, troubling and vexed by the ghosts of past controversy) as can be hoped for." *Id.* at 3. Cf. REPORT, *supra* note 10, pt. I at 61; Note, *Rosenberg v. Rudnick: An Examination of the Potential Conflict Between the After-Acquired Property Provisions of Article 9 of the U.C.C. and Section 60(a) of the Bankruptcy Act*, 15 U.C.L.A.L. REV. 678, 682-88 (1968) (discusses "policy considerations" underlying section 60 in terms of historical concepts only).

20. See Kronman, *supra* note 6, at 111 n.4. In *Worseley v. DeMatos*, 97 Eng. Rep. 407 (1758), Lord Mansfield wrote that a preferential transfer, if due solely to the act and will of the bankrupt, was "not a payment in the regular and commercial course of dealing and business," but rather, was "a fraudulent transaction and therefore void with respect to other creditors." See also *Alderson v. Temple*, 98 Eng. Rep. 165 (1768) (L. Mansfield, J.); 1 W. COOKE, BANKRUPTCY LAWS 376 (4th ed. 1799) ("The delivery of property to a creditor in contemplation of immediate bankruptcy is considered as fraudulent, notwithstanding the delivery is made in satisfaction of a bona fide debt."). The early history of preferences, prior to its judicial adoption by Lord Mansfield in *Worseley v.*

century, however, preference law has been moving in a direction away from the inherent subjectivism of the "fraud" idea²¹ and

DeMattos, is traced by Referee Hotchkiss in *In re Hall*, 4 Am. Bankr. R. 671, 679-81 (W.D.N.Y. 1900):

Preferences were originally lawful. The debtor merely *preferred* to pay one creditor to the exclusion of the others; the debt was a sufficient consideration. That is, they were originally lawful even as against other creditors; but the idea of *pro rata* distribution having been expressed in the statute of 1623, known as 21 Jac. I c. 19 (sec. 7), and human nature being then not unlike that with which we are familiar, the giving of a preference was made a crime and the offender declared liable to lose one of his ears and to sit two hours in the pillory. It was, however, as yet merely a public and not a private wrong.

By the time Lord Mansfield wrote the opinion in *Worseley*, however, the "wrong" had come to be perceived as a form of fraud. "Thus originated the 'conventional fraud' known to the courts and the business world as a preference." *In re Hall*, *supra*, at 680. Similarly, the Supreme Judicial Court of Massachusetts, in a case arising under the National Bankruptcy Act of 1800, described preferences as fraudulent, *Locke v. Winning*, 3 Mass. 324, 325-26, 328 (1807) (Sedgwick, J.):

A principal object of the bankrupt law is that the property of the bankrupt in all his estate, at the time of the act of bankruptcy, *by that act* shall cease; and at the same time, by relation, vest in the assignee, to be *equally* distributed among his creditors, in proportion to the sums respectively due to them. It is most manifest, then, that every act done with intention to defeat this purpose, is a fraud against the law, and therefore void.

....

If indeed it be true, as it undoubtedly is, that every attempt to defeat the public law is fraudulent and void, it then follows, that the *delivery of property to a creditor, in contemplation of bankruptcy, is fraudulent notwithstanding the delivery is made in satisfaction of a bona fide debt.*

Chief Justice Parsons also called it "a fraud upon the other creditors," *id.* at 329. Justice Parker, however, used language suggestive of a more objective theory of preferences:

The fact agreed, that the notes in question were transferred to the defendant in *contemplation of an act of bankruptcy*, appears to me to settle the case. It is true, upon general principles of law, that such a transaction would be good and valid. . . . Where a debtor, in failing circumstances, invites a creditor to take security, or gives to a favorite creditor notice of his circumstances, in order that he may secure himself, contemplating bankruptcy; to support such a preference in a court of law would be to destroy the very end and purpose of the bankrupt system, which is to distribute the effects of the debtor among all his creditors.

Id. at 325.

21. See *Van Iderstine v. Nat'l Discount Co.*, 227 U.S. 575, 582 (1913) ("One is inherently and always vicious; the other innocent and valid, except when made in violation of the express provisions of a statute. One is *malum per se* and the other *malum prohibitum*,—and then only to the extent that it is forbidden."); *Carright v. General Finance Corp.*, 35 F. Supp. 841 (E.D. Ill. 1940), *aff'd*, 123 F.2d 98 (7th Cir. 1941); 3 COLLIER'S ON BANKRUPTCY, *supra* note 3, ¶ 60.03 at 763-66; 2 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 378 at 655 (1940) ("Thus the English preference . . . has a meaning that is very strange to the American lawyer of today.").

toward a set of principles based exclusively upon an objective determination of the financial condition of the debtor and the effect of the alleged preference on third party creditors.²² This development culminates in the proposed Bankruptcy Act, which does away with the vestiges of subjectivism contained in the present section 60.²³ Unfortunately, as the law of preferences outgrew the concept of fraud on which it was originally founded, no general theory appeared to give expression to the principles underlying the objectivist tendencies of this development. As a result, the modern law of preferences emerged in a theoretical vacuum. By and large it has grown through a series of spasmodic reactions to case law developments²⁴ and changing com-

22. The concept of a preferential transfer entered American law in many nineteenth century federal and state bankruptcy acts. At the federal level, an explicit prohibition of preferential transfers first appeared in the Bankruptcy Act of 1841, ch. 9, 5 Stat. 440 (repealed 1843). Under the influence of Justice Story, the American law of preferences gradually developed a theoretical basis distinct from its English predecessor. According to Story, the existence of a preference should depend not upon the debtor's motives or state of mind, but upon his financial condition at the time of transfer. *Everett v. Stone*, 8 F. Cas. 898 (No. 4577) (C.C.D. Me. 1844); *Arnold v. Maynard*, 1 F. Cas. 1181 (No. 561) (C.C.D. Mass. 1842). If a transfer made by an insolvent debtor gave a creditor an advantage over co-creditors, it should be set aside as preferential regardless of the debtor's motives. Story's reasoning was adopted by other courts and finally ratified by the Supreme Court in *Toof v. Martin*, 80 U.S. (13 Wall.) 40 (1871), a case involving the preference section of the Bankruptcy Act of 1867, ch. 176, 14 Stat. 517 (repealed 1878). Thus, what might be called the "objective" theory of preferences has long been accepted in American law. *But cf. In re Hall*, 4 Am. Bankr. R. 671, 693 (Ref. Dec. W.D.N.Y. 1900) (interpreting 1898 Act and distinguishing between "the guilty creditor and the innocent creditor").

For a detailed discussion of the early development of the law of preferences in England and America, see 2 G. GLENN, *supra* note 21, § 378 at 654-59.

23. Section 4-607(a) (1) applies a wholly objective standard in determining preferential treatment during the three month period. Section 4-607(a) (2) of the proposed Act utilizes a "reasonable cause to believe" of insolvency test, but this standard is applicable only to the longer preference period relating to family and affiliates of the debtor:

(a) *Right to Recover.* Except as otherwise provided in this section, a trustee may recover property of the debtor transferred to pay or secure, directly or indirectly, an antecedent debt of a creditor if the transfer occurred when the debtor was insolvent and occurred either

- (1) within three months before the date of the petition or,
- (2) if the creditor was a member of the immediate family, a partner, an affiliate, a director, an officer, or a managing agent of or for the debtor, who had reasonable cause to believe the debtor was insolvent at the date the transfer occurred, within the period commencing one year before and ending three months before the date of the petition. . . .

See also REPORT, *supra* note 10, pt. I at 201.

24. Discussing the evolution of bankruptcy law in general, the Com-

mercial needs²⁵—a process uninformed by any clear conceptual

mission on Bankruptcy Laws concluded that

The course of bankruptcy and related law, policy, and processes has not proceeded continuously and lineally through the centuries toward a broad, evolving goal. Instead, as well exemplified by the history of bankruptcy in the United States, including the events leading to the 1938 amendments to the Act of 1898, the development has occurred spasmodically. Major changes in legislation have been proposed in response to dramatic economic, political and social currents and events and have been enacted after intense debate over broad policy issues and specific objectives.

REPORT, *supra* note 10, pt. I at 62-63. This is especially true with respect to preference law which, since 1898 at least, has been modified repeatedly to resolve problems posed by particular case law developments. Section 60, added to the Bankruptcy Act in 1898, Act of July 1, 1898, ch. 541, § 60, 30 Stat. 562, was amended in 1903, Act of Feb. 5, 1903, ch. 487, § 13, 32 Stat. 799; in 1910, Act of June 25, 1910, ch. 412, § 11, 36 Stat. 842; in 1926, Act of May 27, 1926, ch. 406, § 14, 44 Stat. 666; in 1938, Act of June 27, 1938, ch. 575, § 1, 52 Stat. 869; in 1950, Act of March 18, 1950, Pub. L. No. 461, ch. 70, 81st Cong., 2d Sess., 64 Stat. 24; and minor changes were made in 1963, Act of May 8, 1963, Pub. L. No. 88-17, 88th Cong., 1st Sess., 77 Stat. 14. The major amendments, those occurring in 1938 and 1950, were explicitly formulated in response to evolving Supreme Court doctrine. The 1903, 1910, and 1926 amendments attempted, at least in part, to invalidate judicial protection of "secret transfers"—transfers executed but not disclosed by recording or by the change of possession. For an excellent discussion of this early pattern of court decision and legislative response, see *Hirschfeld v. Nogle*, 5 F. Supp. 234 (E.D. Ill. 1933); see also *Corn Exchange Nat'l Bank & Trust Co. v. Klaunder*, 318 U.S. 434 (1943). However, these early attempts were not well received by the courts. Cases causing most difficulty were: *Carey v. Donohue*, 240 U.S. 430 (1916); *Sexton v. Kessler*, 225 U.S. 90 (1912); *Humphrey v. Tatman*, 198 U.S. 91 (1905); *Thompson v. Fairbanks*, 196 U.S. 516 (1905). In the 1938 amendments to section 60, Congress took dead aim at "equitable liens" of the *Sexton v. Kessler* variety, intending to eliminate them once and for all. See *Hearings on H.R. 6439 & H.R. 8046 Before the House Comm. on the Judiciary*, 75th Cong., 1st Sess., ser. 9, at 123 (1937). But the draftsmen, in utilizing a "bona fide purchaser test" went far beyond their mark and brought down not only equitable liens of the *Sexton v. Kessler* type, but also "non-notification accounts receivable financing arrangements in a great many states and, in all probability, all inventory financing arrangements in all states." 2 G. GILMORE, *supra* note 3, § 45.3.3, at 1302. The overbreadth of the 1938 amendment was clearly perceived by the Supreme Court in *Corn Exchange Nat'l Bank & Trust Co. v. Klaunder*, 318 U.S. 434 (1943); following that case, the draftsmen went back to their drafting boards. The result was the so-called "lien creditor" test embodied in the 1950 amendments to section 60. This new test was designed to mitigate the unintentional severity of the 1938 amendment, without reviving the *Sexton v. Kessler* "relation back" doctrine. See H.R. REP. No. 1293, 81st Cong., 1st Sess. 6 (1949). For a general discussion of the evolution of section 60, see Friedman, *supra* note 3, at 200-04.

25. Accounts receivable and inventory financing developed as commercial necessity broke down the common law's hostility to after-acquired property interests. See 1 G. GILMORE, *supra* note 3, § 2.1 at 25. Recent attempts to revise section 60 of the Bankruptcy Act have neces-

grasp of the guiding principles whose conflict shapes this area of the law.²⁶ The draftsmen's theory represents the first major attempt at formulating a conceptual basis for the modern objectivist approach to preferences.²⁷

Unfortunately, having elevated the discussion of preferences to a new theoretical high, the draftsmen failed to clearly identify the conflicting policies underlying modern preference law.²⁸ This failure, which is reflected in the inadequacies of section 4-607 itself, is of course a disappointment—but a disappointment that illuminates the general problems of preference law in a singularly constructive way. The draftsmen's efforts confirm the necessity of having a general theory as an instrument for the systematic analysis of preference problems and

sarily had to deal with this commercial reality. See 1970 GILMORE COMMITTEE, *supra* note 6, at 17.

26. See, e.g., 2 G. GLENN, *supra* note 21, § 375 at 651: "There is but one conclusion possible, which is that the preference . . . nevertheless must have had a peculiar history, because otherwise one cannot account for these queer differences." Preference law, while moving both in practice and in concept well beyond its quasi-fraudulent antecedents, has stayed nonetheless within the general framework of its original conception. Instead of simply discarding this older complex of ideas and beginning anew, those who have sought to adapt preference law to its modern commercial setting have done so by stretching—indeed, by torturing—its original structural framework. For example, section 60 still utilizes a "knowledge of insolvency" test, which "was once a thing which meant a good deal." *Id.* at 656. The purpose behind this test has become so problematic that the Bankruptcy Commission, in arguing for the abolition of a "knowledge of insolvency" test, was able to assert, quite unequivocally, that such a test does not have "any rational connection with the objective of this provision, i.e., to achieve a more equitable distribution among all of the creditors." REPORT, *supra* note 10, pt. I at 19; see also 1967 GILMORE COMMITTEE, *supra* note 8, at 2-3; G. GLENN, CREDITORS' RIGHTS AND REMEDIES § 434 at 345-46 (1915); cf. Morris, *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN. L. REV. 737, 740-57 (1970).

27. "There is . . . a certain artificiality involved in formulating security interest problems in terms of the preference concept. . . . The artificiality is, however, one that the legal profession has long been used to. . . ." 1967 GILMORE COMMITTEE, *supra* note 8, at 6.

28. In the first place, the draftsmen failed to state, in a clear and precise fashion, the competing interests they were attempting to reconcile. It is true that we are told that the aim of the draftsmen in revising section 60 is "[to resolve] the conflicting interests of the secured and unsecured creditors in the disaster of bankruptcy." However, the content of those interests and the reasons for their inevitable conflict are left unspecified. Because the nature of these conflicting interests is not explicitly stated, the statutory resolution proposed by the draftsmen fails to achieve the very compromise which was their guiding objective. See text accompanying note 88 *infra*; Kronman, *supra* note 6, at 141-50.

provides the foundation for a more complete inquiry into the competing considerations that such a theory must balance.

In what follows, we shall attempt to trace the main outlines of an objective theory of preferences, and to demonstrate that theory's power by applying it to the treatment of security interests in after-acquired property. Our argument proceeds in the following fashion: we begin by identifying the two principal policies which animate preference law and by describing the unavoidable conflict between them. We then consider four distinct schemes for the treatment of security interests in after-acquired property and evaluate each in terms of its success in reconciling these conflicting policies. Simply stated, our thesis is that any preference provision affecting security interests of this sort must realize, simultaneously, two conflicting goals—protection of the secured party's pre-bankruptcy contractual expectations and minimization of the social costs of bankruptcy itself.²⁹

I. BASIC POLICIES UNDERLYING THE TREATMENT OF PREFERENCES

A. THE PRESENT AND PROPOSED BANKRUPTCY ACTS

Under both the present and proposed Bankruptcy Acts, the trustee is empowered to set aside as preferential a limited class of pre-petition transfers³⁰ made by the bankrupt.³¹ In several

29. To be sure, the draftsmen of any preference provision must also consider such factors as certainty, simplicity, and administrative convenience. Our purpose here, however, is to discuss the theoretical underpinnings of preference law in particular, not considerations that bear on legal issues in general. For an extended discussion of the applicability of certainty, simplicity, and convenience in the present context, see generally Kronman, *supra* note 6.

30. The Act's expansive definition of the term transfer indicates the variety of transactions which may potentially constitute voidable preferences under section 60. See Bankruptcy Act § 1(30), 11 U.S.C. § 1(30) (1970), quoted in note 4, *supra*; *Pirie v. Chicago Title & Trust Co.*, 182 U.S. 438, 444 (1901) ("The word [transfer] is used in its most comprehensive sense. . ."); *Irving Trust Co. v. Kaminsky*, 22 F. Supp. 362 (S.D.N.Y. 1937); *In re Muir*, 212 F. 495 (M.D. Pa. 1914); *In re Truitt*, 203 F. 550 (D. Md. 1913).

31. See note 3 *supra*. The basic structure of section 4-607, the proposed Act's voidable preference provision, is relatively straightforward, and conceptually quite different from section 60 of the present Act. Section 4-607(a) defines as preferential all transfers which "occur" within three months of the date the petition was filed if the debtor was insolvent when the transfer occurred. Then, sections 4-607(b), (c), and (d)

respects, however, the proposed Act's definition of this class differs from the definition contained in the present Act.³² One of the most important differences involves the treatment of security interests in after-acquired inventory and receivables. Although the present Act has recently been construed in such a

set forth exceptions to this general rule. Section 4-607(b) contains an exception for transfers of an aggregate value less than \$1,000, for statutory or common law liens "not invalid under section 4-606," and for transfers which do not result in the creditor obtaining "a greater percentage of his claim than other creditors of the same class." Section 4-607(c) contains two exceptions: one for enabling loans, which is comparable to that existing in section 9-107(b) of the Code (although the Code's strict tracing requirement is not repeated, see 1970 GILMORE COMMITTEE, *supra* note 6, at 14) and another "to the extent of new value given at the time of the transfer or at any time thereafter." Section 4-607(d) contains a limited exception for after-acquired receivables and inventory:

(d) *Exception: Receivables and Inventory.* If inventory was acquired or receivables arose and became collateral covered by a security agreement, a perfected transfer of such inventory or receivables or the proceeds of either is not voidable except to the extent that the transferee has improved his position by an increase in the value of the security at the expense of the estate. The transferee has so improved his position if

(1) the debt secured exceeds the aggregate value of all security for the debt three months before the filing of the petition or, if new value was first given under the security agreement during the three-month period, on the date new value was first given; and

(2) the amount by which the debt exceeded the value of the security has been reduced or eliminated by the date of the petition. . . .

REPORT, *supra* note 10, pt. I at 167. The essential operation of this section revolves around its so-called "two-point net improvement test": the value of the collateral three months prior to the filing of the petition is compared with the value of the collateral on the date the petition is filed. If the latter figure is greater than the former, the difference constitutes a voidable preference which can be set aside by the trustee under section 4-607(a). For a discussion of the probable effect of this section, see Kronman, *supra* note 6, at 141-50; note 88, *infra*.

32. The proposed Act, unlike the present Act, makes the creditor's knowledge of his debtor's insolvency irrelevant. Compare section 4-607(a) (proposed Act) with section 60(a) (present Act). Moreover, the proposed Act focuses specifically on the types of transactions that either should or should not be valid, see note 31, *supra*, while the present Act, speaking in vague generalities, depends upon a complex lien-creditor test. See sections 60(a) (2), (6), (7), and (8). See generally REPORT, *supra* note 10, pt. I at 201-11. Indeed, the Gilmore Committee originally contemplated drafting a section that would state simply and explicitly which security interests would be valid in bankruptcy, in what order, and to what extent. 1967 GILMORE COMMITTEE, *supra* note 8, at 6. Although this approach was eventually abandoned as having come "too late in the day," 1970 GILMORE COMMITTEE, *supra* note 6, at 1, the proposed Act's voidable preference section reflects this influence to a certain extent.

way as to insulate perfected security interests in after-acquired property from the trustee's powers under section 60,³³ the proposed Act would make interests of this sort vulnerable, in part, to the trustee's avoiding powers.³⁴

Despite these differences, the voidable preference sections of both the present and proposed Bankruptcy Acts reflect a fundamentally similar approach to the treatment of security interests.

33. See cases cited note 9, *supra*. Of the cases mentioned, *DuBay v. Williams*, 417 F.2d 1277 (9th Cir. 1969), has been the most widely discussed. In *DuBay*, Judge Hufstедler wrote:

Section 60a(2) of the Bankruptcy Act provides that "a transfer of property . . . shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."

Congress did not state that a "transfer" occurs when a security interest attaches or when state law says a conveyance has been made. Congress provided that a transfer is "deemed" to have been made when it became "so far perfected" that no subsequent lien creditor could achieve priority. "Transfer" for the purpose of section 60a(2) is thus equated with the act by which priority over later creditors is achieved and not with the event which attaches the security interest to a specific account.

We look to state law, therefore, only to decide the point at which Rose City's claim to the future accounts was sufficiently asserted to prevent a subsequent lien creditor from achieving priority over it in those accounts. That time was the date upon which Rose City filed its financing statement.

Id. at 1287-88. The Gilmore Committee rightly concluded that, under the logic of *DuBay*, "no perfected Article 9 after-acquired property interest in inventory, receivables or any other type of property can ever be set aside in bankruptcy," 1970 GILMORE COMMITTEE, *supra* note 6, at 17. Ironically, this result extends greater protection to security interests of this sort than even the draftsmen of Article 9 intended. Section 9-108, the Code's own none-too-subtle attempt to keep security interests in after-acquired property from being deemed voidable preferences, contains a significant limitation: only after-acquired property received "either in the ordinary course of his [the debtor's] business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given" is to be given protection under that section. The negative implication of this language is that all other acquisitions are not to be protected. See Comment 1 to § 9-108:

It [this article] does deny present value status to out of ordinary course acquisitions not made pursuant to the original loan agreement. This solution gives the secured party full protection as to the collateral which he may be reasonably thought to have contracted for; it gives other creditors the possibility, under the law of preferences, of subjecting to their claims windfall or un-contemplated acquisitions shortly before bankruptcy.

See also 2 G. GILMORE, *supra* note 3, § 45.6 at 1313-15; 1967 GILMORE COMMITTEE, *supra* note 8, at 17.

34. See note 31, *supra*; Kronman, *supra* note 6, at 134. In fact, the unlimited protection such security interests have received under the present Act was one of the principal stimuli for revision of section 60. See 1970 GILMORE COMMITTEE, *supra* note 6, at 2.

Each scheme represents, at bottom, a compromise that attempts to strike a reasonable balance between voiding all security transfers and voiding none at all. It is clear that both Acts empower the trustee to avoid some security transfers but neither Act makes all transfers of this sort voidable preferences. Only those transfers made within a specified temporal period and to satisfy a particular kind of claim (an "antecedent debt") are even potentially voidable.³⁵ In fact, neither Act permits the trustee to avoid every member of even the limited class of transfers meeting these two requirements.³⁶

This simple observation underscores an important, if often overlooked, fact: while the two Acts differ with respect to where they draw the line between those security transfers that are preferential and those that are not, both rest upon the elementary assumption that neither unlimited protection nor complete invalidation of all the bankrupt's pre-petition security transfers is acceptable.³⁷ Perhaps the most obvious expression of this shared assumption is the limitation, contained in both Acts, that a transfer may be avoided as preferential only if it occurs within a specified period of time immediately preceding the filing of the petition in bankruptcy.³⁸ Although the use of such a "preference period" is desirable for a number of reasons,³⁹ neither Act regards this conceptual device, taken by

35. See § 60(a) (present Act); §§ 4-607(a), (g) (1) (proposed Act).

36. The present Act requires knowledge of insolvency as well, and under the proposed Act a transfer meeting these two requirements may not be voided unless it also meets the "two-point net improvement" test.

37. Cf. REPORT, *supra* note 10, pt. I at 77:

Thus it is both infeasible and unwise for the bankruptcy process simply to adopt the external rules of creditors' rights to carry out a policy of fair and equitable treatment of creditors' claims. Instead, internal standards of two kinds are required: distributive standards that take into account the legal status of claims and allocative standards that reflect the social and economic consequences of the burden of loss.

38. The present Act provides for a four-month preference period, § 60(a), and the proposed Act, a three-month period, § 4-607(a). See also S. 235, H.R. 32, *supra* note 10, at § 4-607 (four-month period). With the exception under the proposed Act of certain transactions of the debtor with family members and business associates, transfers for antecedent debts outside of these time limits are not vulnerable to attack as voidable preferences.

39. REPORT, *supra* note 10, pt. I at 77:

A preliminary distributive standard must establish a set of temporal rules for determining when the goals of the bankruptcy process succeed the goals of external processes in which creditors' claims arise. The standard should provide for a point in time, or series of points in time for different kinds of transac-

itself, as an adequately refined tool for determining which security transfers should be avoided and which should not.⁴⁰ Thus, under both Acts, only certain transfers occurring within the preference period are voidable. In demarcating the class of preference-period transfers that are voidable by the trustee, both Acts introduce additional principles and requirements. However, the principles utilized by each Act differ considerably. The most interesting and controversial differences between the voidable preference sections of the two Acts—and the only ones that will be considered in this Article—are those regarding the treatment of security transfers occurring within the preference period. It is important to note that even with respect to security transfers of this sort, both Acts are in fundamental agreement that neither blanket protection nor unlimited voidability are acceptable alternatives.⁴¹

B. COMPETING POLICIES

The fact that both the present and proposed Acts adopt a middle position between unlimited protection and complete invalidation is due in large measure to the attempt to reconcile two competing considerations,⁴² neither of which is strong enough to warrant exclusion of the other in defining the concept of a voidable preference.⁴³ As both concepts are basic to bankruptcy

tions, prior to the date when the bankruptcy process is invoked. Otherwise, creditors anticipating bankruptcy and utilizing external creditors' rights laws may gain advantages that violate the goal of fair and equitable treatment. Bankruptcy rules avoiding preferential and fraudulent transfers have the objective of undoing such advantages. However, it is equally necessary that the division not be set so far back in time as to upset expectations of creditors relying innocently on the rules of external processes that otherwise apply.

See 3 COLLIER'S ON BANKRUPTCY, *supra* note 3, ¶ 60.01 at 744:

[i]t is obvious that, if the creditors and debtors could deal with impunity with the debtor's assets up to the date of bankruptcy, only tag ends and remnants of unencumbered assets would too often remain. Bankruptcy liquidation would be a futile procedure. The Act, therefore, must necessarily invalidate certain transactions that have occurred prior to bankruptcy.

See also Note, *The Commercial Code and the Bankruptcy Act: Potential Conflicts*, 53 NW. U.L. REV. 411 (1958).

40. See note 36, *supra*. The preference period, to be sure, may be adjusted: the proposed Act shortens the preference period from four months to three. Yet, just as surely, such a mechanism by itself is too blunt an instrument to provide the fine tuning required by the "preference" concept.

41. See notes 36-37 *supra*.

42. G. GLENN, CREDITORS' RIGHTS AND REMEDIES, *supra* note 26, §§ 279-86, at 220-25.

43. We are concerned here with the considerations underlying those

law itself, any preference provision must ultimately reflect an equitable and intelligent balance of the two.⁴⁴

One of the two principal aims of the law of preferences is to protect the contractual arrangements fashioned by the bankrupt and his various creditors during the pre-bankruptcy period.⁴⁵ Taken as a whole, these arrangements define both the nature and extent of the risks which the contracting parties have assumed, and the relative priority of the creditors' competing

aspects of bankruptcy law which deal with how creditors will be treated *inter se*. This is not to slight what is often considered the primary "purpose" of bankruptcy proceedings—the rehabilitation of debtors. See *Fallick v. Kehr*, 369 F.2d 899 (2d Cir. 1966); *Hartman v. Utley*, 335 F.2d 558 (9th Cir. 1964); *In re Schmelzer*, 350 F. Supp. 429 (S.D. Ohio 1972) *aff'd*, 480 F.2d 1074 (6th Cir. 1973); *Aiken v. Bank of Ga.*, 101 Ga. App. 200, 113 S.E.2d 405 (1960); 2 G. GILMORE, *supra* note 3, § 45.1 at 1281; REPORT, *supra* note 10, pt. I at 75. But this purpose, which focuses on the debtor, is unrelated to those interests which should influence the competing rights of his various creditors. And, "[w]hatever purposes bankruptcy attempts to carry out, it does by working on the creditors primarily, by compelling them to reorganize their relations to the debtor or to each other in regard to the debtor's property." Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 9 (1940).

44. Cf. L. FULLER, *THE MORALITY OF LAW* 28 (1963).

45. 2 G. GILMORE, *supra* note 3, § 45.2 at 1284; SENATE COMM. ON THE JUDICIARY, 92ND CONG., 1ST SESS., *BANKRUPTCY STUDY PLAN 4* (Comm. Print 1971). It is clear that

[t]he bankruptcy process affects values on which the open credit economy depends in order to function. The principal such values are orderliness, morality, and skill and knowledge. Orderliness defines the individual authority and power of a debtor and of his several creditors so that the legal consequences of future conduct can be reliably anticipated. Morality and respect are the basis for the reliability that both debtors and creditors will perform in the future as contractually committed. Skill and knowledge enable the participants in the open credit economy to conduct themselves as informed, able contractors in arms length transactions.

REPORT, *supra* note 10, pt. I at 70. The bankruptcy process must proceed in a manner which supports "the values on which the open credit economy depends. . . ." *Id.* at 71. Thus, "[f]or the most part, [claims arising in the open credit economy] should be recognized in the bankruptcy process. Their enforcement serves economic values and honors the outcomes of transactions voluntarily entered, including the parties' contractual expectations about enforcement rights under external rules." *Id.* at 78. See *Coulter v. Blieden*, 104 F.2d 29 (5th Cir.), *cert. denied*, 308 U.S. 583 (1939); *Strauss v. Fidelity & Deposit Co. of Md.*, 143 S.C. 422, 141 S.E. 683 (1927); 2 G. GILMORE, *supra* note 3, § 45.2 at 1287 ("In the structure of the [Bankruptcy Act] there is a sort of built-in tension between the basic prescription that security rights are to be recognized and the administrative procedures which insure that they will be recognized to the smallest degree possible."); cf. *Atlantic Coast Line R.R. v. St. Joe Paper Co.*, 216 F.2d 832 (5th Cir. 1954), *cert. denied*, 348 U.S. 983 (1955); Henson, "Proceeds" *Under the Uniform Commercial Code*, 65 COLUM. L. REV. 232, 252-55 (1965).

claims against the estate of their common debtor.⁴⁶ The reasons for protecting these arrangements, and the bargained-for expectations they embody, are the same as those usually advanced for supporting the expectation interest in contractual dealings generally.⁴⁷ Perhaps the most important of these reasons is that by protecting the expectation interest we increase the rational calculability of profit-making transactions, and thereby encourage the general expansion of credit.⁴⁸ If a trustee in bankruptcy were permitted to use his avoiding powers to nullify, without restriction, the priorities for which the bankrupt's secured creditors have bargained, the use of secured transactions as a financing device would be significantly chilled—perhaps frostbitten.

46. Cf. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946); G. GLENN, *CREDITORS' RIGHTS AND REMEDIES*, *supra* note 26, § 2 at 2-3; Morris, *supra* note 26, at 738.

47. See Fuller & Perdue, *The Reliance Interest in Contract Damages: I*, 46 YALE L.J. 52 (1936); 1 A. CORBIN, *CONTRACTS* § 1 (1963); cf. *Printing & Numerical Registering Co. v. Sampson*, 19 Eq. 462, 465 (1875).

48. It may be said that there is not only a policy in favor of preventing and undoing the harms resulting from reliance, but also a policy in favor of promoting and facilitating reliance on business agreements. . . . Agreements can accomplish little, either for their makers or for society, unless they are made the basis for action. When business agreements are not only made but are also acted on, the division of labor is facilitated, goods find their way to the places where they are most needed, and economic activity is generally stimulated. These advantages would be threatened by any rule which limited legal protection to the reliance interest. . . .

The juristic explanation in its final form is then two-fold. It rests the protection accorded the expectance on (1) the need for curing and preventing the harms occasioned by reliance, and (2) on the need for facilitating reliance on business agreements. From this spelling out of a possible juristic explanation, it is clear that there is no incompatibility between it and the economic or institutional explanation. They view the same phenomenon from two different aspects. The essence of both of them lies in the word "credit." The economic explanation views credit from its institutional side; the juristic explanation views it from its rational side. The economic view sees credit as an accepted way of living; the juristic view invites us to explore the considerations of utility which underlie this way of living, and the part which conscious human direction has played in bringing it into being.

Fuller & Perdue, *supra* note 47, at 61-62. Cf. L. FRIEDMAN, *CONTRACT LAW IN AMERICA—A SOCIAL AND ECONOMIC CASE STUDY* 20 (1965); FRIEDMANN, *LAW IN A CHANGING SOCIETY* 91 (1959); 1 PARSONS, *THE LAW OF CONTRACT* 3 (1855); H. STONE, *THE PROVINCE AND FUNCTION OF THE LAW* 251 (1946); M. WEBER, *THE THEORY OF SOCIAL AND ECONOMIC ORGANIZATION* 179-202 (Oxford 1947); Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 292 (1970); Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 630 (1943). See also F. KESSLER & M. SHARP, *CONTRACTS* 1, 4-9 (1953); R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 3.1 at 41-42 (1972); R. POUND, *AN INTRODUCTION TO THE PHILOSOPHY OF LAW* 133-34, 166 (Rev. ed. 1954).

Like contracts of other sorts, secured contracts embody a set of expectations that cannot be ignored without frustrating the very purpose such transactions are designed to serve. Obviously this result would be undesirable from the standpoint of secured creditors; but more importantly, it would also harm debtors by significantly restricting the availability of credit.⁴⁹

A second and competing aim of the law of preferences is to minimize the inevitable social costs associated with bankruptcy by spreading its impact among all classes of creditors.⁵⁰ If the bankrupt's contractual arrangements with his secured creditors are honored in full and without exception, the bankrupt's insolvent condition will of course impact most heavily upon his unsecured creditors. It is they, in any case, who are bound to bear the brunt of the economic failure that every bankruptcy represents. If made to bear too much, however, the unsecured creditors of the bankrupt may find their own financial health endangered. Every bankruptcy contains within itself the seeds of others, of a chain of failed enterprises radiating throughout the economy. To guard against this danger, which threatens all classes of creditors—indeed, all participants in the economy—the trustee is empowered to avoid the contractual rights of the bankrupt's secured creditors in certain limited cases;⁵¹ by doing so, he can increase that portion of the bankrupt's estate which will be applied to satisfy the claims of general unsecured creditors.⁵² If protection of the expectation interest requires that the

49. Cf. Leff, Commentary, *Economic Analysis of Law: Some Realism About Nominalism*, 60 VA. L. REV. 451, 460-61 (1974).

50. Cf. REPORT, *supra* note 10, pt. I at 78; 2 G. GILMORE, *supra* note 3, § 45.2 at 1287; R. POUND, *supra* note 48, at 162-63, 168.

51. See P. COLEMAN, *DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY* 13 (1974):

... legislators wanted the insolvent's property distributed equitably. They knew that the failure of a single merchant or planter sometimes brought a chain reaction of insolvencies. If losses could be spread fairly over all creditors this might prevent the collapse of any one of them.

52. Thus, it is frequently said, "equality in distribution" is one of the touchstones of bankruptcy law. 2 G. GILMORE, *supra* note 3, § 45.2 at 1287; REPORT, *supra* note 10, pt. I at 75; Krause, Kripke, & Seligson, *supra* note 9, at 282; Kronman, *supra* note 6, at 142; Seligson, *supra* note 3, 15 VAND. L. REV. 115 (1961). See *Canright v. General Finance Corp.*, 35 F. Supp. 841, 844 (E.D. Ill. 1940) ("But the purpose of the Bankruptcy Act is to bring about equality of division of assets amongst creditors. For the rule that to the diligent creditor belongs the reward, the act substitutes the rule that equality is equity."). See also *Simonson v. Granquist*, 369 U.S. 38 (1962); *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941); *Kuehner v. Irving Trust Co.*, 299 U.S. 445 (1937); *Merchants Bank v. Sexton*, 228 U.S. 634 (1913);

priority of secured claims be respected, reduction of the social costs of bankruptcy would appear to require that the priority of such claims occasionally be ignored.⁵³

II. AFTER-ACQUIRED PROPERTY AND THE EXPECTATION INTEREST

We have seen that one of the two fundamental objectives of both bankruptcy law in general, and the law of voidable preferences in particular, is protection of the hierarchical system of claims contractually created during the pre-bankruptcy period by the debtor and his creditors. The organization of this hierarchical system is defined by the separate contracts whose terms establish the jural relation of the bankrupt to each of his individual creditors. These contracts embody and give legal expression to a set of shared expectations that form the basis of the parties' bargain. Viewed abstractly, the particular bargain struck by the bankrupt and any individual creditor may be conceptualized as an agreement regarding the distribution, between the parties, of certain specifiable risks.⁵⁴

Clarke v. Rogers, 228 U.S. 534 (1913); Hansen v. Jonas, 373 F.2d 880 (9th Cir. 1967); Bank of Marin v. England, 352 F.2d 186 (9th Cir.), *rev'd on other grounds*, 385 U.S. 99 (1965); *In re Laskin*, 316 F.2d 70 (3rd Cir. 1963); Stone v. Eacho, 127 F.2d 284 (4th Cir. 1942), *cert. denied*, 317 U.S. 635 (1943); *In re Pusey & Jones Corp.*, 192 F. Supp. 233 (D. Del.), *aff'd*, 295 F.2d 479 (3rd Cir. 1961); *In re Troutman*, 20 F. Supp. 256 (W.D.N.Y. 1937); *In re Houtman*, 287 F. 251 (S.D.N.Y. 1923).

53. REPORT, *supra* note 10, pt. I at 76:

The fulcrum of the balance between the external goals of the open credit economy and internal goals of the bankruptcy process lies here. The individualistic creditors' rights laws, many of which are applicable equally to the enforcement of open credit economy debts and to the enforcement of all other debts, must be balanced in bankruptcy against rules for fair and equitable distribution collectively among all creditors of a debtor.

Cf. L. FULLER, *supra* note 44, at 28; H. HAVIGHURST, THE NATURE OF PRIVATE CONTRACT 20 (1961); F. KESSLER & M. SHARP, *supra* note 48, at 9. In discussing this balance, we start from the apparently undisputed baseline proposition that an ordinary perfected security interest is to be fully protected in bankruptcy. Our focus in this article, therefore, will be on those additional features of a security interest in after-acquired property which may justify different treatment.

54. Patterson, *The Apportionment of Business Risks Through Legal Devices*, 24 COLUM. L. REV. 335 (1924); cf. H. LYON, RISK PROFIT AND LOSS 25-26 (1943); W. SHARPE, PORTFOLIO THEORY AND CAPITAL MARKETS 20-33 (1970); Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUDIES 277, 278 (1972); Cheung, *Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements*, 12 J. LAW & ECON. 23, 25 (1969); Gilmore & Axelrod, *Chattel Security: I*, 57 YALE L.J.

By definition, risk concerns the uncertain happening of future events.⁵⁵ As an instrument of risk-allocation, a contract attempts to order the future⁵⁶ by distributing between the parties the benefits and the misfortunes which its uncertainties may bring. On this view, the particular "price"⁵⁷ one is willing to pay for a specified set of contract rights will depend ultimately upon the conclusions one draws regarding the risk-return relationships among the various future events that may affect the value of the rights in question.⁵⁸ Where two parties have struck

517, 518 (1948); Grayson, *The Use of Statistical Techniques in Capital Budgeting*, in ROICHIEK, *FINANCIAL RESEARCH AND MANAGEMENT DECISIONS* 98 (1967); Hirsch, *Reducing Law's Uncertainty and Complexity*, 21 U.C.L.A.L. REV. 1233, 1234-35 (1974); Girshick, Book Review, 1953 AM. STATISTICAL ASS'N J. 645, 646. This way of thinking about the nature of the contractual obligation is, of course, urged on us by Holmes. See O. HOLMES, *THE COMMON LAW* 299-307 (Little Brown ed., 1881); cf. I. FISHER, *NATURE OF CAPITAL AND INCOME* 265-66 (1906).

55. In investment terminology, applicable here by analogy, "risk" refers to the variance in the return on a given investment. An investment is deemed riskless if a given level of return is guaranteed; it becomes riskier as the chances increase that the return will differ from the expected value. 2 INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 400-01 (1971); cf. F. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* 46-48 (1921) (distinguishes between "risk" and "uncertainty" and argues that the key to the economic ordering of the future is uncertainty). See also C. HARDY, *RISK AND RISK-BEARING* 1 (2d ed. 1931) ("Risk may be defined as uncertainty in regard to cost, loss, or damage. In this definition, emphasis is on the word *uncertainty*"); H. LYON, *supra* note 54, at 3 ("By economic risk we will mean uncertainty of having more or less in the future than we have in the present."); J. VANHORNE, *FINANCIAL MANAGEMENT AND POLICY* 134 (3d ed. 1974).

56. R. POSNER, *supra* note 48, § 3.1 at 41-42; cf. P. SAMUELSON, *ECONOMICS* 595 (8th ed. 1970) (referring to Professor Knight's "important theory" that "all true profit is linked with uncertainty").

57. Price is being used here not simply to refer to a dollar figure, but rather to encompass the array of economic agreements which a contract may embody. Thus, the "price" of a contract to a secured party includes not only how much he will lend, but a host of related considerations as well (for example, those dealing with the amount and quality of collateral).

58. A party to a contract is concerned not only with expected return, but also with the degree of risk associated with an expected return. See S. BOLTON, *SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT* 4, 132-38 (1972); V. BRUDNEY & M. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 56, 1109 (1972); J. FRANCIS & S. ARCHER, *PORTFOLIO ANALYSIS* 14-17 (1971); W. LEWELLEN, *THE COST OF CAPITAL* (1969). Thus, a secured party peering into the future will attempt to construct a matrix of risk-return probabilities by attaching a quantum of risk to different possible levels of return. V. BRUDNEY & M. CHIRELSTEIN, *supra*, at 49-66; Note, *Giving Substance to the Bonus Rule in Corporate Reorganizations: The Investment Value Doctrine Analogy*, 84 YALE L.J. 932, 942 n.47 (1975). From such a matrix, an "expected value" of return may be calculated by multiplying the probabilities times their associated vari-

a bargain, it is reasonable to assume that each favorably regards the allocation of future risks accomplished by the terms of their agreement and reflected in the contract price.

A secured contract with an after-acquired property clause, like any other contract, may be regarded as a device for the allocation of risk. To determine the nature of the risk allocation associated with an after-acquired property clause, it is necessary to isolate the risks peculiar to a specialized contract of this sort. These special risks define, in part, the expectation interest of a creditor with a contract right secured by after-acquired inventory or receivables; they represent a portion of the "price" he is willing to incur for the debtor's collateralized promise to repay.

Before we can describe the risk allocation embodied in the contractual bargain that a creditor with a security interest in after-acquired property has struck with his debtor, it is first necessary to catalogue the possible (and always, to some extent, unforeseen) future events that might affect the value of the creditor's collateral. Against the background of this preliminary analysis, it should be fairly simple to trace the contours of the secured creditor's expectation interest.

Events affecting the value of a security interest in after-acquired property fall into four general categories. The first category (and the most rewarding one, from the standpoint of a creditor with a security interest of this sort) includes all events occurring in the ordinary course of the debtor's business that increase the overall value of the creditor's collateral. The idea of an increase in the "ordinary course" of business is a familiar

ous possible levels of return and aggregating the results of these multiplications. H. BIERMAN & S. SMIDT, *THE CAPITAL BUDGETING DECISION* 161-92 (4th ed. 1975); Grayson, *supra* note 54, at 98-107. That is, where O_i represents the i th possible level of return, and P_i represents its associ-

ated probability, the expected value (E) may be defined as: $E = \sum_{i=1}^n P_i O_i$. The expected value, along with the measure of the "spread" of the

distribution, called the weighted variance (V), defined as $V = \sum_{i=1}^n P_i$

$[(O_i - E)^2]$, are what a party uses to calculate what he will pay for a contract. See W. SHARPE, *supra* note 54, at 20-33. See generally S. ARCHER & C. D'AMEROSIO, *BUSINESS FINANCE: THEORY AND MANAGEMENT* 85-103 (1972); W. MENDENHALL, *INTRODUCTION TO PROBABILITY AND STATISTICS* 90-96 (2d ed. 1967); W. SPURR & C. BONINI, *STATISTICAL ANALYSIS FOR BUSINESS DECISIONS* 156-57, 195-99 (1967); J. VANHORNE, *supra* note 55, at 135-39; T. YAMANE, *STATISTICS: AN INTRODUCTORY ANALYSIS* 227-36 (1967). For purposes of this Article, we shall only be using the term "expected value" as defined above.

one;⁵⁹ yet surprisingly enough, it has never been defined in precise economic terms. For the purpose of this Article we will use a definition of gains in the ordinary course of business which, although not the only possible one,⁶⁰ has the twin advantage of facilitating analytic precision while capturing the intuitive meaning which the phrase has in everyday use. In the most general sense—which is the sense adopted here—a particular event may be said to occur “in the ordinary course of the debtor’s business” if calculation of the probability of its future occurrence rests upon “objective” factors.⁶¹ To be objectively determinable, a particular probability need not be statistically calculable with undeviating precision. Rather, calculation of the likelihood of a future occurrence is objective when it rests upon widespread public agreement regarding the considerations that bear on the calculation in question, and a well-developed and detailed historical record that permits sound empirical conclusions to be drawn respecting those same considerations. Of course, even the most objective calculation will contain an irreducible element of uncertainty.⁶² To be convinced that this is so,

59. Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.

U.C.C. § 9-108. See 2 G. GILMORE, *supra* note 3, § 45.6 at 1315; 1970 GILMORE COMMITTEE, *supra* note 6, at 16-17; Skilton, *Buyer in Ordinary Course of Business Under Article 9 of the Uniform Commercial Code (and Related Matters)*, 1974 Wis. L. Rev. 1.

60. See text accompanying notes 73-74 *infra*.

61. Grayson, *supra* note 54, at 98-107; Von Mises, *Probability: An Objectivist View*, in E. MANSFIELD, *ELEMENTARY STATISTICS FOR ECONOMICS AND BUSINESS* 59-67 (1970).

62. Grayson states that “[a]ll probabilities are subjective,” and continues by suggesting:

It is perfectly true that if there is a great amount of “objective” data, say on interest rates in the past, then these data should be considered and will *strongly influence* the subjective probability assignments to future interest rates. In fact, research has shown that two decision makers with roughly the same objective data or past experience, will assign to a future event roughly the same subjective probabilities if they believe the future will be similar to the past. But, if one forecaster thinks that there may be a structural shift in the economy, or has a direct pipeline to the Federal Reserve Board’s thinking, he may alter or throw away past data in making his probability assignments, and it is perfectly valid for him to do so.

Grayson, *supra* note 54, at 98. See also H. LYON, *supra* note 54, at 5 (“When contracting for the future thing each man forecasts its future

one need only recall Hume's famous observation that predictions about the future, based on the record of the past, are always premised on an assumption that this record itself can never justify: the assumption that the future will conform to the past, and will be regular in the same *kind* of way.⁶³ Despite the presence in all predictions about the future of a residual uncertainty of this sort, we are convinced that a meaningful distinction can be drawn between predictions based on objective factors and those that are not.⁶⁴

Of course, in practice no bright and magical line demarcates these two classes of predictions: we have presented them as ideal types that represent merely the theoretical poles of a real continuum.⁶⁵ As ideal types, however, they have great explanatory power.⁶⁶ In what follows, we shall assume that an event occurs in the ordinary course of the debtor's business if a prediction of the likelihood of its future occurrence approximates the ideal type of objective prediction. For the sake of simplicity, all increases in the value of a creditor's collateral resulting from events occurring in the ordinary course of the debtor's business will be termed "ordinary course gains."⁶⁷

Common examples of ordinary course gains include increases in the value of the creditor's collateral due to a general and anticipated expansion of the debtor's business (including a seasonal and therefore cyclical rather than permanent expansion),⁶⁸ and increases that result from the routine manufacture or assembly of collateral. The probability of such an increase actually occurring will always be less than one,⁶⁹ since each of

value to himself."); L. SAVAGE, FOUNDATIONS OF STATISTICS 3 (1954); W. SPURR & C. BONINI, *supra* note 58, at 202.

63. D. HUME, A TREATISE OF HUMAN NATURE Bk. I, pt. III, § 6 (1739); D. HUME, AN INQUIRY CONCERNING HUMAN UNDERSTANDING pt. IV, § 1 (1748).

64. Cf. W. SPURR & C. BONINI, *supra* note 58, at 141; Grayson, *supra* note 54.

65. Cf. L. SAVAGE, *supra* note 62; Grayson, *supra* note 54. Indeed, a gain will often be composed of a combination of both. See note 67 *infra*.

66. M. WEBER, *supra* note 48, at 92; M. WEBER, THE METHODOLOGY OF THE SOCIAL SCIENCES 42-47, 83-112 (1949).

67. Ordinary course gains involve not only the *fact* of increase, but also the magnitude of increase. In few real-life situations will the magnitude of the increase be predictable with anything close to certitude—there are simply too many other variables in the world to allow such simplification. See note 58 *supra*.

68. Cf. REPORT, *supra* note 10, pt. I, at 210; Hogan, *supra* note 9, at 564-65.

69. P. SAMUELSON, *supra* note 56, at 582.

the increases just enumerated might be prevented by some foreseen or unforeseen contingency, such as a labor dispute, the loss of a lawsuit, or a storm or bombardment by a foreign enemy. Nevertheless, in each case the likelihood of the increase is objectively determinable given certain information about the debtor, his history, and his current financial condition.⁷⁰ This is so because, in each case, there is widespread agreement regarding the relevant questions that analysis of such information is expected to answer.

Paralleling the class of ordinary course gains is that of ordinary course losses. These may be defined as *decreases* in the overall value of the creditor's collateral that result from events occurring in the ordinary course of the debtor's business—decreases whose likelihood is objectively predictable. Examples include a decline in the value of the debtor's inventory, where the debtor is engaged in a seasonal industry and the decline follows immediately upon his usual period of peak sales; or a decline in the value of a particular piece of fixed equipment due to wear and tear, obsolescence, and other normal processes of depreciation.

In addition to the two classes of events described thus far, ordinary course gains and losses, there are two others that may affect the value of a security interest in after-acquired property. We shall call these "windfall gains" and "windfall losses" respectively.⁷¹ The unifying characteristic of all windfall events, whether foreseen or totally unexpected, and the essential fact that distinguishes them from ordinary course gains and losses is the (relative) absence of an objective basis for determining the likelihood of their actual occurrence.⁷² An adequate objective

70. See W. SHARPE, *supra* note 54, at 25-26. See also note 67 *supra*; F. KNIGHT, *supra* note 55, at 234:

. . . [I]t does not matter how unique the instance, if a real probability can be calculated, if we can know with certainty how many successes there *would be* in (say) one hundred trials if the one hundred trials could be made. . . . But in business situations it so rarely happens that a probability can be computed for a single unique instance that this qualification has less weight than might be supposed. However, insofar as objective probability enters into a calculation, it is hard to imagine an intelligent individual considering any single case as absolutely isolated. . . . The importance of the contingency and probable frequency of recurrence in the individual lifetime of situations similar in the magnitude of the issues involved should make a difference in the attitude assumed toward any one case as well as the mathematical probability of success or failure.

71. U.C.C. § 9-108; REPORT, *supra* note 10, pt. I at 210; 1967 GILMORE COMMITTEE, *supra* note 8, at 17-18; Kronman, *supra* note 6, at 144-49, 155.

72. These may be called "subjectively" determined probabilities.

basis may be lacking either because no consensus has been reached regarding the considerations relevant to such a determination, or because the historical record is relatively incomplete and ambiguous.

In what follows, it is important to remember that the distinction between foreseen and unforeseen events is merely related to—and not identical with—the distinction between ordinary course and windfall events as we have defined them. While it is plausible to assume that a creditor reflecting on the risks associated with a particular contractual venture will be more likely to contemplate and consider gains and losses which may arise in the ordinary course of his debtor's business, and arguably less likely to contemplate windfall gains and losses, there is no necessary connection between the character of the event and the fact of its being either foreseen or unforeseen.⁷³ Such a connection would of course exist if we were simply to define windfall events as those whose occurrence was unforeseen at the time the contract was negotiated. We have rejected this definition because it obscures the important conceptual distinction between those future events which are both foreseen and objectively determinable, and those which are foreseen but whose likelihood cannot be predicted on an objective basis.⁷⁴

See W. SPURR & C. BONINI, *supra* note 58, at 142: "A subjective probability is an evaluation by the decision-maker of the relative 'likelihood' of unknown events." Subjective probabilities are personalistic in character, and rest upon the assumption "that it makes a great deal of sense to talk about the probability of a *single event*, without reference to the repeatability, long-run frequency concept." Grayson, *supra* note 54, at 98-107. See also D. FARRAR, *THE INVESTMENT DECISION UNDER UNCERTAINTY* 1-7 (1962). Under a subjective view of probability, "no probability is unknown to the person concerned, or, at any rate, he can determine probability only by interrogating himself." L. SAVAGE, *supra* note 62; cf. F. KNIGHT, *supra* note 54, at 233 (distinguishing "measurable uncertainties" from "unmeasurable uncertainties").

73. The "character" of an event relies on precisely identifiable (one is tempted, but for the confusion, to use the term "objective") factors; that is to say, the "character" of an event is determined simply by noting the presence or absence of an historical record. The character of an event, however, being determined objectively, has no necessary connection to the event being foreseen or unforeseen, for the latter determination depends on a party's private state-of-mind. That is to say, while an event may be objectively *foreseeable*, one cannot know whether or not it is actually *foreseen* by a person without probing the mind of that individual. Since that is so, it is perfectly possible for an objectively *foreseeable* (e.g., ordinary course) event to be unforeseen; equally, it is possible for a windfall event to be foreseen.

74. There is another, more practical, reason for rejecting a definition based on the individualistic state of being foreseen or unforeseen. Such a definition rests upon a person's state of mind, which is a particularly

We have also chosen not to define windfall events as those which are unforeseeable, rather than merely unforeseen. Every future event is in principle foreseeable,⁷⁵ in the sense that its possibility can be contemplated in advance. In our view, it is more illuminating to ask whether the likelihood of a particular future event is objectively determinable than it is to ask whether the event can be foreseen at all.

Of course, an individual may still predict the likelihood of any future occurrence, despite the absence of an objective basis for doing so.⁷⁶ However, where an objective basis is not present to any significant degree, any such prediction must rest upon one's own idiosyncratic or subjective views regarding both the considerations relevant to the construction of a risk-return matrix, and the conclusions to be drawn from the available historical information.⁷⁷ Put somewhat differently, the weaker the objective basis for calculating the likelihood of some possible future event, the less reason there is to believe that the calculation of one individual will coincide with that of another. Two or more calculations of this sort may coincide; but in the limiting case, where there is no objective basis whatsoever for the calculations in question, such a coincidence will be entirely accidental.

A windfall event, then, may be defined as an occurrence whose prediction rests upon subjective rather than objective factors. It should be stressed, once again, that an utterly subjective calculation is as much an ideal type as a calculation that is perfectly objective in character. Both exist in theory only. No doubt, ordinary course gains and losses may be of primary importance to both the secured party and his debtor in framing the terms of their contractual relationship because they are objectively determinable and therefore a subject for rational calculation and bargaining. Nevertheless, windfall gains and losses represent real risks which may affect the value of the creditor's collateral and which a secured contract allocates be-

unsuitable foundation on which to rest a factual determination. It makes proof of an issue that much harder—and the possibility of perjury that much greater. A party that said "I foresaw that event"—as would be the temptation if a question of entitlement rested upon such a perception—could force an unsatisfactory factual issue on the trier of fact.

75. See L. SAVAGE, *supra* note 62.

76. W. SPURR & C. BONINI, *supra* note 58, at 142; Grayson, *supra* note 54.

77. See note 72, *supra*; cf. C. CLARK & L. SCHKADE, *STATISTICAL METHODS FOR BUSINESS DECISIONS* 147 (1969).

tween the parties. Examples of windfall gains and losses include the following: 1) an increase in the value of the debtor's inventory resulting from the unanticipated imposition of an export embargo by a new and revolutionary government upon all products of the debtor's chief foreign competitor; 2) a decrease in the value of the debtor's inventory and equipment due to the revolutionary invention of a new, and less costly, process of manufacture in the debtor's own line of business; and 3) the contraction or expansion of the debtor's receivables following a change in the monetary policy of the Federal Reserve Board, the effect of which is either to reduce or increase the overall cost of credit in the economy as a whole.⁷⁸

With these four categories of risk in mind we are now in a position to describe the expectations of a creditor with a security interest in after-acquired property regarding fluctuations in the value of his collateral. Since our main concern is with determining the extent to which these expectations are protected or upset in bankruptcy, we shall limit our discussion to fluctuations occurring within the statutorily established pre-bankruptcy preference period.

The behavior of a rational creditor is easy to describe. In determining the advantages of a proposed security arrangement, he will first identify all of the relevant risks⁷⁹ that may affect the value of his collateral. Of course, in so doing he will know that he has not identified all of the risks that may conceivably be involved. No human being could ever do this. Although by definition he does not know what these unforeseen risks are, he will treat the aggregated benefits and burdens they represent as equal to zero,⁸⁰ and therefore as factors that are not themselves rel-

78. Cf. Grayson, *supra* note 54.

79. The concept of "limited attention" suggests that, in reality, a party does not explicitly consider all possible future events—indeed, that would be an infinite chore. Rather, he selects and analyzes those events which he considers central. Cf. *Parev Prods. Co. v. I. Rokeach & Sons, Inc.*, 124 F.2d 147, 149 (2d Cir. 1941); *Société Franco Tunisienne d'Armement v. Sidermar S.P.A.*, 2 Q.B. 278 (1960). See generally Farnsworth, *Dispute Over Omission in Contracts*, 68 COLUM. L. REV. 860, 868-69 (1968).

80. This conclusion is supported by the so-called "principle of insufficient reason":

This principle is used to assign probabilities to outcomes in the absence of any information. When we have no evidence at all, the possible cases are taken to be equally probable. Thus Laplace reasoned that when we are drawing from two urns each containing a different ration of black to red balls, but we have no information as to which urn we are faced with, then we should assume initially that the chance of drawing from each

evant in deciding whether to enter the contract at any given price.⁸¹ Because unforeseen risks factor out in this way, we will only describe the contractual allocation of those risks that the creditor has actually identified.

Where the risks are associated with ordinary course gains and losses (and such risks are quite likely to be identified because their prediction rests upon considerations and historical data which the parties share and comprehend), it is surely correct to assume that the creditor expects to reap their benefits and bear their burdens respectively. The pleasant prospect of the one together with the uneasy apprehension of the other form the core of his expectation interest. Are the risks associated with windfall gain and loss also contractually allocated between the parties? At first blush, an affirmative answer might appear to be counter-intuitive. If the likelihood of windfall gains and losses can be estimated on the basis of subjective factors only, it might seem unreasonable to regard the contract as a deliberate

of these urns is the same. The idea is that the state of ignorance on the basis of which these prior probabilities are assigned presents the same sort of problem as the situation where one has a lot of evidence showing that a particular coin is unbiased. What is distinctive about the use of the principle is that it enables one to incorporate different kinds of information within one strictly probabilistic framework and to draw inferences about probabilities even in the absence of knowledge. . . . The limiting case of no information does not pose a theoretical problem.

J. RAWLS, *A THEORY OF JUSTICE* 168-69 (1971). See also W. FELLNER, *PROBABILITY AND PROFIT* 27 (1965); F. KERLINGER, *FOUNDATIONS OF BEHAVIORAL RESEARCH* 56-57 (1964).

81. An important theoretical qualification does not affect our central concern, which rests on the fact that these unpredicted events have an aggregate expected return which may be presumed to be zero. The theoretical qualification focuses on risk, and not return. The fact that the return on unforeseen events is presumed to be zero does not mean that these factors may not affect the contract price; they may, depending on the party's perception of their aggregate importance vis-a-vis identified future risks. That is to say, presuming our parties to be risk averse, a high risk contract with an expected return of zero (the hypothetical flip of a coin where heads represents a \$10,000 gain and tails a \$10,000 loss) will be worth less than a low risk contract with an expected return of zero (a \$5 gain on heads and a \$5 loss on tails). See generally W. LEWELLEN, *supra* note 58. Similarly, a contract perceived to be relatively risky—of which a factor will be the perceived relative proportion of unforeseen risks vis-a-vis foreseen risks—will carry a lower contract value than a contract of equal expected return perceived to be relatively risk free. This qualification, however, which is concerned with how risk affects value, does not affect our primary concern here, which needs to rely only on the balance between unforeseen gains and losses, which we do know.

"meeting of the minds"⁸² that embodies an agreement respecting the distribution of such risks.

Although the bargain struck by the parties may be based on substantially different subjective perceptions concerning the likelihood of future windfall events, it is true nevertheless that each has contracted on the basis of a particular set of expectations regarding the risks entailed by contingencies of this sort.⁸³ From the creditor's point of view the risk-return matrix associated with all future events, windfall as well as ordinary course, must be a favorable one, at least given the contract "price" on which the creditor and his debtor have agreed; were this not so, the creditor would have been unwilling to enter the contract in the first place. It seems plausible to conclude, therefore, that a secured party "expects" to receive all gains and to suffer all losses that may be characterized as windfalls in the technical sense used above. For this reason, an allocation of windfall risks that lets windfall losses lie, while depriving the secured party of any windfall gain, would interfere with his bargained-for expectation interest.⁸⁴

III. TREATMENT OF THE EXPECTATION INTEREST IN BANKRUPTCY

The value of a security interest in after-acquired property will, of course, fluctuate with the value of the collateral itself. In the preceding section, we suggested that a secured party has the

82. *Woburn Nat'l Bank v. Woods*, 77 N.H. 172, 175, 89 A. 491, 492 (1914); L. FULLER & M. EISENBERG, *BASIC CONTRACT LAW* 257 (3rd ed. 1972); Williston, *Mutual Assent in the Formation of Contracts*, 14 ILL. L. REV. 85 (1919). On the question of "risk," the so-called "grubstake contract" cases are instructive. See, e.g., *Emobola v. Tuppella*, 127 Wash. 285, 220 P. 789 (1923).

83. This follows from two prior assumptions: first, that the probability of all events may be subjectively calculated by a party, see notes 62 & 72, *supra*; and second, that a rational party will contract based upon such a calculation, cf. W. SHEARPE, *supra* note 54, at 24-26; W. LEWELLEN, *supra* note 58. It follows that a party, in reaching a decision as to whether or not to enter a given contract at a particular price will consider his calculation of the expected value of windfall as well as ordinary course events. Cf. Llewellyn, *What Price Contract?—An Essay in Perspective*, 40 YALE L.J. 704, 722-26 (1931).

84. A similar point has been made forcefully by Professor Brudney in discussing the Bankruptcy Commission's proposed "second look" into corporate reorganizations, Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305 (1974). See also Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 HARV. L. REV. 1786 (1974).

following contractual expectations with respect to the four categories of risk previously identified: On the one hand, he has bargained for, and expects to receive, all ordinary course and windfall gains; on the other hand, he has assumed the risk of, and expects to suffer, both ordinary course and windfall losses. Together these four elements of risk allocation constitute the expectation interest of a creditor with a security interest in after-acquired property, so far as fluctuations in the value of his collateral are concerned. How is this expectation interest treated in bankruptcy, under the preference sections of the present and proposed Acts?

Under the present Act, it has been clear for some time⁸⁵ that the secured party's expectation interest, as defined above, will be protected completely in bankruptcy.⁸⁶ As section 60 is presently construed, a creditor with a security interest in after-acquired property receives the benefit of all increases in the value of his collateral during the pre-bankruptcy preference period whether due to windfall or ordinary course events. Similarly, he suffers all decreases in the value of his collateral during the same period—again, regardless of the nature of the event causing the loss. This, of course, is precisely the distribution of risk for which the secured party bargains. Because it does not in any way interfere with this distribution, section 60 gives unqualified protection to the secured party's expectation interest.

The "two-point net improvement test" adopted in the preference section of the proposed Act⁸⁷ treats the secured party's expectation interest less generously. Because it flatly condemns all "improvements" in the position of the secured party that occur during the preference period,⁸⁸ the proposed Act deprives him of both ordinary course and windfall gains. At the same

85. *DuBay v. Williams*, 417 F.2d 1277 (9th Cir. 1969).

86. See text accompanying note 33 *supra*.

87. Section 4-607 (proposed Act).

88. Following Professor Homer Kripke's suggestion, see Letter from Professor Homer Kripke to the Commission on the Coordination of the Uniform Commercial Code and the Bankruptcy Act, Sept. 17, 1970, in REPORT, *supra* note 10, pt. I at 210, the draftsmen of § 4-607 incorporated language which states that the improvement in the position of a creditor must be "at the expense of the [debtor's] estate" to be voidable by the trustee. § 4-607(d). This language, however, appears to be without effect since the section goes on to state that the creditor who has improved his position within the meaning of the "two-point net improvement" test, has, by definition, improved his position at "the expense of the estate." See § 4-607(d) (quoted in note 31 *supra*). See also Kronman, *supra* note 6, at 154-55.

time, it does nothing to redistribute ordinary course or windfall losses. Thus, while the secured party must sustain both types of losses, as he must under the present Act, he loses the benefit of both types of gain that the present Act permits him to retain.

Although the language of the proposed preference section seems to require this result,⁸⁹ it is not entirely consistent with the general theory of preferences that the draftsmen of that section offered to elucidate and justify its provisions.⁹⁰ One of the authors of this Article has suggested elsewhere that the "two-point net improvement test" be modified to better reflect the analysis and conclusion embodied in the draftsmen's theory.⁹¹ It is unnecessary to recapitulate the reasons adduced in support of the suggested modifications;⁹² but it is important for our purposes to note the impact these modifications would have on the contractually-defined expectation interest of a creditor with a security interest in after-acquired property. Under what we shall call the "modified proposed Act," a creditor with a security interest of this sort retains only those preference-period gains (to the extent they represent net improvements) that occur in the ordinary course of the debtor's business; by contrast, he is deprived of all windfall gains, and made to suffer all losses, windfall or ordinary course.⁹³ Thus, the modified proposed Act frustrates the expectation interest of the secured party only to the

89. Kronman, *supra* note 6, at 146-47; see note 88, *supra*.

90. Kronman, *supra* note 6, at 146-47.

91. *Id.*

92. *Id.*

93. Our principal object has been to describe the conceptual differences between these four categories of risk. Of course, in an actual bankruptcy proceeding it remains to be determined in which category any particular gain or loss is to be placed. In establishing a procedure for making such determinations, a variety of factors should be kept in mind. See REPORT, *supra* note 10, pt. I at 81-82; 1970 GILMORE COMMITTEE, *supra* note 6, at 17; Kronman, *supra* note 6, at 145-50. As the draftsmen of section 4-607 themselves recognized, it is the case that "[i]n the normal course of a business declining into bankruptcy the position of an inventory or receivables lender, far from improving, will almost certainly deteriorate." 1970 GILMORE COMMITTEE, *supra* note 6, at 17. Because this is so, it is reasonable to begin with the presumption that any increase in the value of collateral occurring during the preference period represents a windfall gain. This presumption should be a rebuttable one, however: the secured party should be permitted, in every case, to show that his gain has occurred in the ordinary course of his debtor's business. To do so, the secured party would need to show that the risk of such a gain was an objective one in the twofold sense discussed above. See text accompanying notes 61-62 *supra*. See also Kronman, *supra* note 6, at 149.

extent that it deprives him of the benefit of windfall gains.⁹⁴ For this reason, it may be viewed as a distinct alternative to both the present and proposed Acts. We shall treat it as such.

IV. COMPARISON AND EVALUATION OF COMPETING PREFERENCE SCHEMES

Having identified three different schemes for treating a creditor's expectation interest regarding fluctuations in the value of after-acquired property, we now propose to evaluate each alternative, first in terms of its attractiveness to the secured party, and then, as a means of reconciling the basic policy conflict that underlies preference law. From the standpoint of the secured party himself, we find—not surprisingly—that the three can be ranked in a definite order of preference. It is clear that the secured party will prefer the modified proposed Act to the proposed Act in its unmodified form, for while the former gives him a benefit—ordinary course gains—that the latter does not, the burdens he must bear are the same in both cases. For similar reasons, the secured party will prefer the present Act to the modified proposed Act: the first gives him all the benefits of the second, and more—windfall gains—without imposing any additional burdens.

It is an easy matter to evaluate the relative attractiveness of these three preference schemes from the perspective of the secured party because he is interested in advancing but one of the underlying policies whose conflict constitutes the principal dilemma that the law of preferences must resolve. The secured party will quite naturally favor protection of his contractual expectation interest to the exclusion of anything else.⁹⁵ Conse-

94. Kronman, *supra* note 6, at 144-50.

95. Just as the class of secured creditors may be said to be the proponents of one of the two policy considerations at work in preference law, so too, their unsecured counterparts, as a class, may rightly be called the standard-bearers of the competing policy consideration, see Kronman, *supra* note 6, at 142. The referees in bankruptcy, generally drawn from the class of attorneys who represent unsecured creditors, are the acknowledged champions of the position that "equality is equity." 2 G. GILMORE, *supra* note 3, § 45.2, at 1287-88. The following, not surprisingly, is from the Fifth Seminar for Referees in Bankruptcy, held in 1968:

It is quite obvious that Article 9 of the Uniform Commercial Code was not written by bankruptcy lawyers or at least those customarily representing trustees in bankruptcy. The philosophy of its provisions honestly seems to me to be that financial institutions, or perhaps in some cases major suppliers are deserving of higher rights than are employees, service trades, government, professional people or anyone else. It seems to reject

quently, when we shift our focus and evaluate these same three schemes in terms of their comparative success in reconciling the competing policies that form the foundation of preference law, it is perfectly understandable that a different rank order should emerge.

The ordering that results when one adopts this broader and more complex perspective is similar in one important respect to the hierarchy of preference schemes that would be established by the secured party himself. From either perspective, the advantages of the modified proposed Act outweigh those of its unmodified counterpart. We have already seen why the secured party will draw this conclusion. The modified proposed Act also offers a more satisfactory resolution of the fundamental policy conflict underlying preference law in general. The proposed Act, in its unmodified form, resolves this conflict by simply refusing to protect the creditor's expectation interest in any but the most *Pickwickian* sense. By depriving the secured party of the benefit of any preference period increase in the value of his collateral, the unmodified proposed Act denies him the most valuable element of his bargained-for expectation interest. To be sure, the proposed Act, as it now stands, would "protect" his expectations regarding losses sustained during the preference period. But this is hardly an advantage from the secured party's perspective. By denying him the benefits of his contract with the debtor, while requiring him to bear its burdens, the unmodified proposed Act effectively destroys the expectation interest of the secured party and upsets the balance of benefits and burdens on which his bargain with the debtor is founded.

the idea that those who took the risk of extending credit to a man in business should in the event of his failure share in proportion to the amount of credit they have outstanding or in other words, *pro rata*. In its place, there are provisions under which the large and diligent financial institution can substitute a device under which it can say in effect "This debtor belongs to me. All that he now owns and all that he owns in the future are subject to what he now owes me and what credit I may choose to advance him in the future. I need make a matter of public record little more than the fact that I have this security on everything. I need not know at any given point of time what specific property is security for my claims and he need not account to me if I do not choose to require it. I can allow him as complete freedom as I choose, but in case he gets into trouble, then he is mine. After I am satisfied in full, then anyone else who desires may share in the gleanings."

This device is loosely termed "the floating lien"
Statement of Referee Daniel R. Cowans, Tenth Round Table Discussion, contained in PROCEEDINGS OF THE FIFTH SEMINAR FOR REFEREES IN BANKRUPTCY 337 (1968).

By shifting at least some of the costs of bankruptcy from the class of unsecured creditors to those holding security interests, the unmodified proposed Act reduces the overall economic dislocation that bankruptcy is apt to cause. In so doing, it advances one of the principal objectives of preference law. Unfortunately, it achieves this result by flatly disregarding the other interest that preference law must protect: the contractual expectations of the debtor's creditors. The modified proposed Act, however, strikes a balance between these two objectives. On the one hand, it deprives the secured party of the benefit of all windfall gains occurring during the preference period; to this extent, it frustrates his contractual expectations and shifts to him a financial burden that would otherwise be borne by the bankrupt's unsecured creditors. On the other hand, it permits the secured party to retain the benefits of all ordinary course gains: to this extent, it protects his contractual expectations and preserves his priority *vis-à-vis* unsecured claimants. The modified proposed Act therefore represents a genuine compromise; the unmodified proposed Act does not.

Similarly, the modified proposed Act offers a better balance of these competing policies than does the present Act. This, of course, reverses the rank ordering the secured party himself would establish.⁹⁶ As we have seen, he prefers the present Act because it protects his contractual expectations in an unqualified fashion. It is precisely for this reason, however, that the present Act must be regarded as an inadequate compromise between conflicting policies. Since it does not deprive the secured party of any of the benefits for which he has bargained, the present Act fails to redistribute the costs of bankruptcy and thereby soften its social and economic impact. This, in its own way, is as one-sided and uncompromising a solution as that embodied in the unmodified proposed Act. While the present Act bestows total protection upon the expectation interest of the secured party, under the unmodified proposed Act the same interest is not protected at all. The latter may of course make sense as a polemical response; however, it no more strikes a balance between the conflicting interests, whose struggle animates preference law, than does the scheme contained in the present Act.

Because it is the task of any preference scheme to achieve a compromise between these interests, both the present Act and the proposed Act, in its unmodified form, offer solutions to the

96. See text accompanying note 95 *supra*.

basic dilemma of preference law which are less satisfactory than that contained in the modified proposed Act. Each emphasizes one of the competing policies to the exclusion of the other; neither strikes a balance between the two. The preference scheme contained in the modified proposed Act, on the other hand, represents a genuine compromise that offers considerable protection to the expectation interest of the secured party, while at the same time effecting a partial redistribution of the inevitable social costs of bankruptcy. The principal strength of the modified proposed Act is that it strikes a balance between competing policies. We believe the balance is a sensible one.⁹⁷

At this point, it is tempting to consider whether we can devise a fourth preference scheme that would effect as substantial a redistribution of costs as that achieved by the modified proposed Act, without infringing as seriously upon the interests of secured creditors as a class. If a scheme of this sort is possible, it would strike a balance preferable to the one contained in the modified proposed Act. Does such a scheme exist?

We may begin by specifying the way in which the modified proposed Act fails to completely protect the secured party's expectation interest. As we have already seen, the secured party expects windfall gains and losses to be treated symmetrically,⁹⁸ in that he has bargained both for the benefit of windfall gains, and for the burden of windfall losses. Under the modified proposed Act, however, these risks are treated in an asymmetrical manner: the secured party is deprived of windfall gains, but made to suffer windfall losses. Such asymmetrical treatment skews his pre-bankruptcy contractual expectations. The suggestion that a secured party does not bargain for windfall gains and that he may therefore be deprived of them without interfering with his contractual expectation interest⁹⁹ rests upon the widely

97. There are, of course, numerous ways in which a compromise between these two competing policies may be reached, as well as numerous points at which the balance may be struck. While we do not pretend that the modified proposed act provides the only real, or feasible, compromise, we do believe it is sensible, in that the basis for the compromise rests upon distinctions that are commonplace: a distinction between ordinary course events and windfall events. These concepts are familiar, even if the definitional method we have chosen here is not. The recognition of a meaningful distinction between these two types of events, when coupled with the probability that ordinary course events will provide the stimulus for entering such a contract, *see* text accompanying note 78 *supra*, provides a rational compromise, without serious adverse effects on the marketplace for credit.

98. *See* text accompanying notes 83-84 *supra*.

99. Kronman, *supra* note 6, at 144:

held, but incorrect, belief that windfalls are not "deserved."¹⁰⁰ We have seen, however, that windfall gains do form a part of the secured party's contractual expectation interest. There may be strong policy reasons for depriving him of these gains, while leaving him with his windfall losses, but this result cannot be defended on the ground that it accurately reflects the secured party's bargained-for expectations.¹⁰¹

This asymmetry might be cured by constructing a preference scheme that would compensate the secured party for windfall losses, while depriving him of windfall gains. Such a scheme would modify the secured party's pre-bankruptcy contractual entitlements by depriving him of a right he had bargained for (the right to windfall gains), while investing him with one for which he had not bargained (the right to be compensated for windfall losses). Despite this interference with the secured party's expectation interest, the scheme in question would neutralize the overall impact of windfall events upon secured creditors as a class.¹⁰² Although the treatment accorded any particular creditor under this scheme would differ from that provided under the present Act,¹⁰³ in the aggregate the claims of secured creditors as a class would receive nearly identical treatment under either arrangement. For this reason, our hypothetical fourth scheme may be regarded as functionally equivalent to the present Act, insofar as the interests of secured creditors as a class are concerned. It should be noted, however, that any *individual* creditor might well prefer the present Act to a scheme of this sort if he were convinced for subjective reasons

Secondly, and not as obviously, a secured party should be denied the benefit of any "windfall" increase in the value of his collateral during the immediate pre-bankruptcy period. . . . Since the secured party did not bargain for a windfall of this type, he has not given anything to the debtor's estate, by way of consideration, that might entitle him to appropriate to himself the entire benefit of the windfall.

Cf. U.C.C. § 9-108, Comment.

100. R. POSNER, *supra* note 48, at 84.

101. For a demonstration of the validity of a similar assertion, see Brudney, *supra* note 84; cf. Note, *supra* note 58, at 942-43 n.48.

102. The expected value of windfall gains equals the expected value of windfall losses, when considering them in the aggregate. See, e.g., F. KERLINGER, *supra* note 80, at 56-57; cf. Fama, *Random Walks in Stock Market Prices*, in E. ELTON & M. GRUBER, *SECURITY EVALUATION AND PORTFOLIO ANALYSIS* 42 (1972); L. LAPIN, *STATISTICS FOR MODERN BUSINESS DECISIONS* 382-83 (1973).

103. It would upset the contractual arrangement whereby the secured creditor got to keep windfall gains and was forced to suffer windfall losses.

that his chances of reaping a windfall gain exceeded those of incurring a windfall loss. Only as a class will secured parties necessarily be as well-protected under the fourth scheme as they are under the present Act.

Unfortunately, from the broader perspective of preference law as a whole, our fourth scheme is as seriously deficient as both the present Act and the proposed Act in its unmodified form. Under our fourth scheme, secured creditors would occasionally lose the benefit of windfall gains to which they would otherwise be entitled; at the same time, and just as frequently,¹⁰⁴ they would be compensated for windfall losses they would otherwise have to absorb. As a result, secured creditors, as a class, would be as well off under the fourth scheme as they are under the present Act.¹⁰⁵ In neither case will the costs of bankruptcy be significantly redistributed between secured and unsecured creditors as a class. From a broad policy standpoint, therefore, this fourth preference scheme is certainly no better than the one set out in the present Act and may be inferior to the present scheme because of the special administrative difficulties it poses.¹⁰⁶ For reasons already explored,¹⁰⁷ we therefore conclude that this fourth possible scheme is distinctly inferior to the one contained in the modified proposed Act, and that the latter represents the only treatment of preferences that protects the expectation interest of the secured party in a qualified fashion, while simultaneously effecting a partial redistribution of the costs of bankruptcy itself.

V. CONCLUSION

It has been our aim, in this Article, to delineate the basic features of an objective theory of preferences, and to demonstrate the instrumental value of such a theory by using it to evaluate the relative merits of four distinct solutions to one of the most vexing problems in preference law: the treatment of security interests in after-acquired property. Our principal thesis may be stated quite simply: the success of any preference

104. See text accompanying note 102 *supra*.

105. See note 102 *supra*.

106. The administrative costs of intervention to resolve disputes that arise from this reversal of contractual entitlements would appear to be substantial. And, of course, administrative cost is a real factor to weigh in considering bankruptcy statutes. REPORT, *supra* note 10, pt. I, at 81-82.

107. See text accompanying notes 95-96 *supra*.

provision that empowers a trustee in bankruptcy to avoid certain security transfers occurring within a specified temporal period will depend upon the extent to which the preference scheme in question is able to realize, simultaneously, two conflicting goals—protection of the secured party's pre-bankruptcy contractual expectations, and minimization of the social costs of bankruptcy itself. Because these goals inevitably conflict, no preference scheme can realize both in an unqualified fashion. If both are to be realized, each must also be compromised to some extent. This general theoretical premise is the touchstone we have employed in evaluating the treatment of security interests in after-acquired property under the four preference schemes considered in this Article. To what extent the theoretical model offered here may be useful in the analysis of other preference problems is, of course, an open question. We are, however, optimistic that it may be fruitfully applied to other areas of preference law. Our optimism is based on two facts: one is the generality of the theory itself, and the other is its demonstrated success in illuminating the most intractable—the most written about¹⁰⁸—problem in contemporary preference law.

Only under the modified proposed Act is the treatment of a security interest in after-acquired property based on a genuine compromise between the competing and independently desirable goals of protecting the secured party's expectation interest and minimizing the social costs of bankruptcy.¹⁰⁹ Of the three remaining schemes that we have considered, none embodies a compromise of this sort, at least with respect to the transfer of security interests in after-acquired property occurring within the stipulated pre-bankruptcy period.¹¹⁰ From the necessarily one-sided perspective of the secured party himself, the modified proposed Act is less attractive than the present Act because it upsets his expectations regarding the treatment of windfall events and the objectively incalculable risks they represent. When viewed from the broader perspective of a general theory of preferences, however, this dissatisfaction and apparent illogic¹¹¹ may be seen for what it truly is: the reflection of the logic

108. See Kronman, *supra* note 6, at 122-31.

109. Reconciling protection of the expectation interest with other and competing policies is a familiar problem in other areas of commercial law. See generally R. POUND, *supra* note 48, at 166; Note, *The Economic Implications of the Doctrine of Impossibility*, 26 HASTINGS L.J. 1251 (1975).

110. See text accompanying notes 38-41 *supra*.

111. The apparent illogic comes from the asymmetry, see text accompanying notes 98-101 *supra*.

of compromise itself. One of the powerful attractions of this theory of preferences is that it allows us the luxury of a principled choice in an area of the law where principles have remained elusive and inarticulate. This may not be a reason for adopting the theory, but it is surely one of the collateral benefits of doing so.